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Applying The Business Judgment Rule To Director Pay Claims

By **Robert Quirk and Muhammad Faridi** (April 5, 2018, 11:27 AM EDT)

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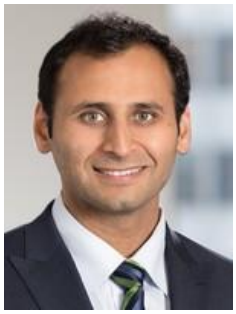

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What legal standard applies to an assessment of a corporate board's refusal to pursue litigation in response to a shareholder's "demand" to take "all necessary actions" to correct alleged misconduct by directors related to their compensation? In Solak v. Fundaro,[1] Commercial Division Justice Charles Ramos ruled that since the shareholder had asked the board to take "all necessary actions" in a letter that the court construed as a "demand" under Rule 23.1 of the Delaware Chancery Court Rules, the shareholder conceded that the board was independent and disinterested. Thus, according to the court, the shareholder action is subject to the business judgment rule and the shareholder must plead particularized facts showing gross negligence or bad faith to proceed with a derivative claim.

Origin of the Dispute

The dispute in Solak concerned the compensation of nonemployee directors of Intercept Pharmaceuticals Inc. In 2016, Intercept's board of directors adopted a nonemployee director compensation policy that provided for various cash and stock compensation for its directors. This policy was not submitted to the company's shareholders for approval.

John Solak, an Intercept shareholder, sent a letter to the board in March 2017 alleging that the directors' compensation was excessive. The letter requested that the board take "all necessary actions," including revising the stock awards and cancelling all stock awards that had been issued under the plan until an appropriate policy could be devised and approved by shareholders.[2]

The board adopted a revised compensation policy in April 2017 with slightly reduced levels of compensation. The board also replied to Solak's letter in July 2017, indicating that it had conducted an investigation, including review by Radford, an independent compensation consultant hired by the board.[3] The response to Solak's letter also stated that the allegations in the letter would have an "'extremely low probability of success on the merits,"' and that it would not be in Intercept's best interest to take further action beyond the usual review of Intercept's policies.[4]

Solak then filed a derivative suit on behalf of Intercept against the nine members of the board. The suit alleged breach of fiduciary duty, waste of corporate assets and unjust enrichment. The board members

moved to dismiss the claims.

Application of Demand Rule under Delaware Law

The board's motion to dismiss asserted that the letter was a shareholder demand under Rule 23.1 of the Delaware Chancery Court Rules that was properly refused under the business judgment rule.[5] Solak argued that the letter was not a Rule 23.1 demand for legal action, that he did not assert a demand because the demand would have been futile, and that the board's actions should be evaluated under the "entire fairness" standard without the benefit of the business judgment rule's presumption of good faith. [6] The "entire fairness" standard "requires the board of directors to establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price."[7]

Justice Ramos ruled that the letter was a Rule 23.1 demand. Under Delaware law, which applied because Intercept is a Delaware corporation, a Rule 23.1 demand must identify "'(i) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder wants the board to take on the corporation's behalf.'"[8]

The court found that the first two requirements were expressly met by the plain text of the letter. As to the third requirement, although the letter did not specifically request that the board file a lawsuit, it did "demand that the board take all necessary actions [sic]" and noted that, if the board did not act within 30 days, Solak would consider "available actions and remedies in order to compel the board to act for the benefit of Intercept and its shareholders."[9] The court concluded that "all necessary actions" included any available legal actions and thus the letter was a Rule 23.1 demand.

The court found that by sending a Rule 23.1 demand, Solak conceded that the board is disinterested and independent.[10] Thus, his suit was not governed by the "entire fairness" standard, but by the business judgment rule.

Business Judgment Rule

The court explained that decisions concerning the management of a corporation, including whether to engage in litigation, fall under the business judgment rule.[11] That rule establishes a presumption that directors act in good faith to further the best interest of the company.[12] That presumption can be rebutted through assertion of "'particularized facts that raise a reasonable doubt as to whether the board's decision to refuse the demand was the product of valid business judgment.'"[13] If the party rebuts the business judgment presumption by showing that the board has breached its duty of care, loyalty or good faith, the board then must show that "'the challenged act or transaction was entirely fair to the corporation and its shareholders.'"[14]

The court noted that the demand imposed on Solak a burden to "raise reasonable doubt that (1) the board's decision to deny the demand was consistent with its duty of care to act on an informed basis, that is, was not grossly negligent; or (2) the board acted in good faith, consistent with its duty of loyalty."[15]

As to the first prong of this test — whether the board was grossly negligent — the court noted that a shareholder must demonstrate "that the board failed 'either to investigate the demand at all or in pursuing such an inadequate investigation, in light of the seriousness of the demand, … a court may reasonably infer a breach of the duty of care.'"[16] A breach of the duty of care occurs "only when the

directors fail to inform themselves fully and in a deliberate manner."[17]

The board argued that Solak could not show a breach of the duty of care because the board had retained a law firm, met to discuss its response to the letter, consulted with Radford, and interviewed the members of the Compensation Committee. In addition to this internal work, the board also studied the compensation of the directors of a "peer group" of companies selected by Radford and approved by the Compensation Committee because they were similar to Intercept in several respects, including "'stage of development, market capitalization and number of employees.'"[18]

Solak responded by arguing that the peer group was not a legitimate universe for comparison because it consisted mostly of Radford clients that were not similar to Intercept on measures of revenue and profits.[19]

The court rejected Solak's argument, reasoning that his critiques of the Peer Group were not sufficient to raise an inference of gross negligence. Furthermore, the court noted that when directors rely on an expert "selected with reasonable care," they are entitled to protection under Section 141(e) of the General Corporation Law of Delaware.[20] Since Solak's complaint did not offer facts that would undermine Radford's competence on compensation matters, the court held that the board was entitled to Section 141(e) protection from claims of bad faith or gross negligence.[21]

Turning to the second ground for rebutting business judgment rule — bad faith — Solak was likewise unsuccessful. The court noted that to show bad faith, a plaintiff must plead facts that reveal a decision "so inexplicable that a court may reasonably infer that the directors must have been acting for a purpose unaligned with the best interest of the corporation."[22] The court held that Solak had failed to allege bad faith given the numerous steps taken by the board to evaluate director compensation.[23]

Since Solak had not successfully alleged either gross negligence or bad faith, the court held that Solak's action could not proceed in light of the required deference to the board's decisions under the business judgment rule.[24]

Conclusion

Justice Ramos held in Solak that a corporate board's response to a demand for "all necessary" action will be accorded the deference of the business judgment rule unless a plaintiff can come forward with specific facts showing bad faith or gross negligence. In so holding, the court refused to adopt the view that a Rule 23.1 demand must specify exactly what actions are requested by the objecting shareholder.

The holding that a request for "all necessary" action constitutes a Rule 23.1 demand has particular significance in cases in which the alleged conduct giving rise to the derivative claims would not typically be accorded the deference of the business judgment rule. The court rejected the argument that director compensation decisions are inherently self-interested and thus the entire fairness rule governs claims against a board accused of excessively compensating itself. The court did so on the basis that the shareholder had made a demand on the board, which amounts to a concession "that the board is disinterested and independent for the purpose of responding to the demand, meaning that the board did not breach its duty of loyalty."[25]

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[1] Solak v. Fundaro, No. 655205/2017, 2018 BL 104975 (N.Y. Sup. Ct. March 19, 2018).

[2] Id.at *1-2.

[3] Id.at *2.

[4] Id.

[5] Id.at *3.

[6] Id.

[7] Id.at *4.

[8] Id.at *3-4 (quoting Yaw v. Talley, No. Civ. 12882, 1994 Del. Ch. LEXIS 35, at *22-23 (Del. Ch. Ct. March 2, 1994) (citing Allison v. General Motors Corp., 604 F. Supp. 1106, 1117 (D. Del 1985)).

[9] Id.at *4.

[10] Id.at *5 (citing Andersen v. Mattel Inc., C.A. No. 11816, 2017 Del. Ch. LEXIS 12, at *8 (Del. Ch. Ct. Jan. 19, 2017).

[11] Id.at *4-5.

[12] Id.at *5.

[13] Id.at *5 (quoting Friedman v. Maffei, C.A. No. 11105, 2016 Del. Ch. 63, at *24 (Del. Ch. Ct. Apr. 13, 2016)).

[14] Id.at *5 (quoting In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006)).

[15] Id.at *5 (quoting Friedman, 2016 Del. Ch. 63, at *24).

[16] Id.at *5 (quoting Ironworkers Dist. Council v. Andreotti, C.A. No. 9714, 2015 Del. Ch. LEXIS 135, at *89 (Del. Ch. Ct. May 8, 2015), aff'd, 132 A.3d 748 (Del. 2016)).

[17] Id.at *5 (citing Cede & Co. v. Technicolor Inc., 634 A.2d 345, 367 (Del. 1993)).

[18] Id.at *6.

[19] Id.

[20] Id.at *6 (citing Crescent/Mach I Partners L.P. v. Turner, 846 A.2d 963, 985 (Del. Ch. 2000)).

[21] Id.at *7.

[22] Id.at *7 (quoting Andreotti, 2015 Del. Ch. LEXIS 135, at *89).

[23] Id.at *7

[24] Id.

[25] Id.at *5.